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ADDING CHANNELS:

A Proposed Approach for Restoring Incentives To Carry New Programming Services

COX CABLE COMMUNICATIONS, INC.

and

NEWHOUSE BROADCASTING COMPANY

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INTRODUCTION

Last year, the Commission adopted its initial rules implementing the rate regulation provisions of the Cable Consumer Protection and Competition Act of 1992. Those rules established a "benchmark" approach that established maximum permissible per-channel rates for systems, based on the system's number of channels, number of subscribers, and number of satellite services carried. Once a system's initial per-channel rates were determined from the benchmark table and formula, subsequent increases would be limited to the rate of inflation and, in addition, to any increases in "external costs" -- which were defined to include taxes, expenses required by the franchising authority, and programming costs -- to the extent that such increases exceeded inflation.

Those rules did not make clear, however, how maximum permissible rates would be affected by the addition (or deletion) of channels of programming. Was the system simply supposed to multiply its established maximum per-channel rate by the number of channels added and increase its rates by that amount? Or was it supposed to go back to the benchmark table and find the maximum permissible per-channel rate for systems with its new total number of channels and multiply that rate by the total number of channels to find the new maximum rate that it could charge? In addition or alternatively, was the system to be allowed to pass through to subscribers the increased programming costs that were associated with adding the new channels?

To resolve these questions, the Commission issued its Third Further Notice of Proposed Rulemaking last summer. In its Fourth Report and Order, the Commission adopted answers that will, in combination with the further rate reductions mandated by its Second Reconsideration Order, almost certainly make it impossible and uneconomical for cable operators to add new channels of programming to regulated tiers. And this means that there will be no future for new program services that have little brand-name recognition and little ability to survive as à la carte offerings.

Cox Cable Communications and Newhouse Broadcasting Company have historically made room on their systems for new services of this sort -- services that appeared promising but that required an incubation period to gain exposure and to prove their appeal (or lack of appeal) to subscribers. There have always been costs and risks associated with adding new and untested services, but we and the programmers have in the past been able to share these costs and risks in ways that enabled us to nurture the development of the diverse array of services now available to subscribers. The new rules, however, limit our ability to cover the costs and bear the risks of adding new services to our regulated tiers. And, as a result, they provide disincentives to add channels of programming to regulated tiers;

the only practical alternatives are to use new channels for unregulated services or to forgo the addition of channels altogether. Therefore, unless the Commission acts quickly to revisit and revise its approach, fledgling program services that have been waiting and withering while cable operators waited to see what the rules would allow will expire and no new services will be born.

THE ECONOMICS OF ADDING PROGRAMMING

To understand why the new rules don't work, it's first necessary to understand the costs, benefits, and risks involved in adding a new channel of programming to a regulated tier of service. The costs include, of course, the expense of building and activating new channel capacity and the fees paid by operators to newly added program services. But they also include "opportunity costs" -- foregone net revenues from alternatives to adding channels to regulated tiers. Those alternatives include using channels to provide services that are not subject to rate regulation -- for example, premium services and pay-per-view programming. They also include the option of simply not adding or activating channels at all. If the cable operator's expected gain from adding channels to regulated tiers does not exceed the gain from one of these alternatives, it will not add such channels.

What are the potential benefits to the cable operator of adding channels to regulated tiers? Historically, cable operators have had two distinct incentives to add new channels of programming to their basic and enhanced basic tiers, and these incentives have fostered the multitude and diversity of non-premium satellite programming services that currently exist. First, cable operators added channels in order to attract more subscribers -- that is, to increase their penetration. Second, they added channels to tiers in order to increase the value of the tiers to existing subscribers.

To the extent that new channels of programming attracted new subscribers, operators could increase their revenues without even increasing rates, and this would reduce the size of any rate increases that might be necessary to compensate for the costs and risks incurred in adding the channels. To the extent that the new channels enhanced the value of cable service to existing subscribers, cable operators could increase their rates without losing subscribership, thus further increasing their revenues.

During the 1980's -- and especially during the period of rate deregulation that began at the end of 1986 -- cable operators were able to count on both increased penetration and increased value to existing subscribers when they added new channels of satellite-delivered programming. During this period, as new channels were added (and the quality of existing programming services improved), cable penetration grew rapidly. At the same time, cable operators were able to increase rates, which indicates that the value of cable service to all subscribers also increased correspondingly.

But towards the end of the period of deregulation, the steady growth in penetration began to taper off. There are now more than 70 satellite-delivered services available to cable operators and subscribers, and it is becoming less and less likely that the addition of new non-premium services will be able to win over a significant number of those consumers who have not yet been attracted by the existing array of services. This suggests that, increasingly, the point of adding new channels to tiers of programming will have to be to increase the value of those tiers to existing subscribers, and that the costs of adding such channels will have to be recouped almost entirely from increased rates rather than from increased subscribership.

These circumstances would create a difficult environment for new program services, even in the absence of rate regulation. Cable subscribers have demonstrated that they value additional program choices and that they are willing to pay more when new services are added to a tier, even before they know what the programming is or whether it will turn out to be especially attractive. But whether they are willing to pay enough to compensate the programmer for the full costs of the programming plus an amount that is sufficient to compensate the cable operator for the costs and risks associated with adding the programming is another question.

Fortunately, new programmers typically have not charged cable operators fees at the outset that are intended to compensate them fully for the costs of their programming. In part, this is simply because neither cable subscribers nor cable operators are able and willing to pay such amounts for untested and unknown programming. But new programmers are usually willing, in these circumstances, to provide their services at very low cost to cable operators in order to have an opportunity to reach subscribers and to prove their mettle. If the service is attractive to subscribers, the programmers will be able to recover their costs, ultimately, from increased operator fees in the future.[1/]

Programmers may also be able to recover some portion of their costs from advertising revenues. The availability of advertising revenues is important. It means that even if

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1/ Indeed, a programmer that provided its service to cable operators at a very low fee at the outset might expect to recover an increasing share of the increased revenues from subscribers as the popularity of the service increased -- which it could attain if its fee to cable operators increased by a greater percentage than the cable operator's rate to subscribers. Once a service becomes attractive to even a small portion of a system's subscribers, it becomes difficult for the system to drop the service. This affects the amount that the programmer might obtain from the operator if the service proves successful -- but it also limits the operator's long-term expected benefits and therefore affects the operator's cost-benefit analysis in deciding whether and on what terms to add a new programming service.

programmers provide their services, initially, at very low cost to cable operators, the extent to which they will ultimately be required to increase their rates to operators if they are successful will be mitigated by such revenues. It also means, however, that programmers that expect to depend on advertising revenues to supplement operator fees need exposure to the widest possible audience; for such services, availability as an à la carte offering at unregulated rates may not be a viable option.

What if the program service never catches on with viewers? In that case, adding a channel to carry the service will never be useful in increasing subscribership to the tier. And it will never provide the hoped for long-term benefits of substantially increasing the value of (and the amount that subscribers will be willing to pay for) the tier. The operator's only return will be that revenue that represents the difference between the value to subscribers of an additional choice of an unknown service (a value that will dissipate as the service becomes known and unwanted) and the amount charged by the programmer to the operator (an amount that is likely to be low at the outset and is unlikely to be raised significantly if the service has no appeal to subscribers). Ultimately, as the service loses its value to subscribers, the low rates charged to systems will produce, at best, minuscule profits and, at worst, substantial losses for the programmer. And, as a result, the service will go out of business or be dropped -- although this may be delayed by the fact that dropping even a generally unpopular service from a system is likely to make at least some subscribers unhappy. Meanwhile, the operator has foregone the opportunity to use the channel for some more productive use -- either by carrying a more successful service on the tier or by carrying some other type of service (such as a premium or pay-per-view service) -- or to have prevented its losses by not building the extra channel capacity in the first place.

So, in deciding whether or not to add a new channel of programming, a cable operator has to balance the expected costs and benefits. What is the likelihood that the service will be successful, and what is the likely payoff if it is successful? What are the likely revenues to be gained and the likely costs to be incurred if the service is not successful? How much do I need to receive in the early years, when success is undetermined, in order to hedge against the possibilities (1) that the service will be unsuccessful and (2) that the service will be successful but will demand, at that point, a higher fee.

These considerations apply whether or not a system is subject to rate regulation. But regulation can skew the analysis to the extent that it limits or otherwise affects the amounts that can be charged, and therefore affects the expected revenues to be obtained by cable operators in the short-term and the long-term. No "going-forward" approach can perfectly replicate the marketplace. But to the extent that a particular approach reduces the expected gains from adding a channel of regulated programming to levels that are negative or are, in any event, less than what might be gained from alternative uses of the channel -- or from alternative uses of the money used to build the channel -- it is obvious that new programming services will not be added to regulated tiers.

THE COMMISSION'S APPROACH: PROGRAM COSTS PLUS A MARK-UP

The Commission's approach ostensibly has two components. When a system adds a channel, it is entitled to increase tier rates by a flat amount that supposedly represents the costs of adding a channel other than the programming costs. In addition to this flat amount, the additional programming costs associated with the new channel are treated as "external costs" -- that is, the system can pass through such additional costs plus a 7.5% mark-up.

In practice, however, the non-programming component turns out to be relatively insignificant, especially in systems with more than a handful of channels. The Commission used its benchmark formula to calculate the extent to which rates would supposedly differ among systems with different numbers of channels. In other words, it looked at the difference in <u>average</u> rates between systems with different channel capacities. This is not, of course, the same thing as observing the extent to which particular systems actually <u>changed</u> their rates when they <u>added</u>

channels. And, in any event, it results in an allowable increase for the non-programming component of adding channels that is, in most cases, very small. For most systems, the Commission's table allows an increase of only a penny or two for the <u>entire tier</u> when they add a channel.

Thus, the Commission's approach for adding channels consists, in reality, of a pass-through of new programming costs plus a 7.5% mark-up. Such an approach is precisely the wrong way to replicate marketplace incentives and to ensure the availability of new programming services. Indeed, the Commission's approach effectively eliminates any incentives that a cable operator might have had to add new channels of programming to regulated tiers.

Allowing cable operators to charge subscribers what they pay plus a percentage mark-up makes it impossible for programmers to induce operators to carry their service by providing it at little or no cost. What programmers seek to do by offering their service to operators, initially, at a very low price is to enable the operator to capture most or all of the added value of the new tier to subscribers. But if, instead of being able to increase rates by an amount that reflects that added value, the operator can only raise rates by the amount that he pays the programmer plus a 7.5% mark-up, there is no way to achieve this objective.

Suppose, for example, that after adding a new service to its basic tier, a cable operator would be able profitably to increase basic rates by 50 cents -- assuming that it obtained the programming at a price of 10 cents per subscriber. In other words, the new programming would add sufficient value to basic service that a sufficient number of subscribers would be willing to pay an additional 50 cents, so that the increased revenues to the operator would be just enough to cover the costs of adding and activating the channel and provide the operator with a reasonable expected profit, taking into account the costs and benefits associated with the possible success or failure of the service. The programmer might be delighted to offer the programming on these terms; ten cents per subscriber might be sufficient to cover its costs, or the programmer might be willing to forgo revenues at the outset in order to build viewership, advertising revenues, and brand-name recognition.

But such an arrangement is impossible under the new rules. The operator cannot increase rates and retain an 80% share of the "split" -- the division of subscriber revenues between operator and programmer. It is limited by the rules to retaining less than a 7% share of the split. For example, the only way that the operator can raise rates by 50 cents per subscriber is if it pays the programmer 46.51 cents per subscriber and passes through this amount plus a 7.5% mark-up (3.49 cents per subscriber). Stated another way, to retain 40 cents for itself, an operator must pay the programmer $5.33 and add a 7.5% mark-up of 40 cents, so that the increase in basic rates after adding the channel is $5.73! Or, as a general proposition, to retain a certain amount for itself, the cable operator must pay the programmer 13 times that amount, and it must charge subscribers 14 times that amount. This, of course, is absurd. No new programming services can be added under an approach that limits rate increases to the cost of programming plus a 7.5% mark-up.

A MODIFIED BENCHMARK APPROACH

A better approach would be one that allowed cable operators to charge, at the outset, an amount that represented not the cost of the programming to the cable operator but the cable operator's real costs -- including the cost of adding and activating the channel plus the opportunity cost of foregoing other uses of the channel. Therefore, instead of allowing a rate increase that covers the cost of the added programming plus a percentage mark-up on that cost, it would be preferable to allow an increase that covers the cost of the programming plus a fixed amount that is intended to compensate for the other, non-programming costs associated with adding channels.

There is unlikely to be any scientific method that will identify with precision the amount that is just sufficient to cover those costs and that is, therefore, just enough to give the operator an incentive to add the channels. As noted above, the formula proposed by the Commission in the Third Further Notice mistakenly equated the observed difference in rates between systems with different numbers of channels with the reduction in per-channel rates that a particular system would have implemented if it had increased the number of channels of programming on its system. A survey of how rates of particular systems actually changed when they added channels during the period of deregulation might have provided a more appropriate measure of the extent to which existing allowable per-channel rates should decline when channels are added to regulated tiers. In the absence of such data, the determination of an appropriate fixed mark-up on new programming will necessarily be somewhat arbitrary.

The task is to establish a mark-up that enables operators to recover their real costs of adding channels and gives them sufficient incentives to add such channels while avoiding, to the extent possible, the risk that some operators might add programming that is not only inexpensive but truly worthless, simply as a way to raise rates back up to the same levels that subscribers were previously willing to pay for existing services. That risk may, in any event, be illusory. First, several bona fide programming services with quality programming are currently vying for scarce channel capacity and have already indicated a willingness to make their programming available at very low rates to cable operators. It is hard to imagine why a cable operator would choose to add inexpensive junk in order to raise rates to subscribers if it could implement the same rate increases and enjoy the same revenue increases by adding quality programming. The latter approach offers at least some possibility of increased revenues in the future.

Moreover, even if there were no such quality programming services available at low cost, it would be unlikely that cable operators would opt to waste channels on worthless programming rather than use such channels for alternative, unregulated services, such as pay-per-view and interactive services, that provide a greater potential return. Cable's history is one of constant investment in and experimentation with new services that add long-term value to program packages and offerings. Excessive rate regulation could, indeed, create artificial incentives that disrupted such investment and experimentation. But the greater risk is not that, by setting allowable rates too high, cable operators will add channels of junk. It is that, by setting allowable rates too low, they will be unable to add new services to regulated tiers even when such services might, in an unregulated environment, be not only attractive to cable operators and subscribers but also more attractive than alternative uses of their channels.

Nevertheless, there are ways to mitigate any risk that operators might add worthless low-cost channels simply as a means of restoring rates to their former, unregulated levels. First, as a general matter, the fixed mark-up should probably be set at a level that, when added to the minimal costs charged by the least expensive new programmers, results in an amount that is less than what most systems are allowed to charge, on a per-channel basis, for their existing services. It is probably fair to assume that subscribers would put a lesser value on a new service than on the average established service on the tier. They would not, in other words, pay more, on a per-channel basis, for a new, unknown service than they pay for existing services -- even if the operator's costs of adding the channel justified such a higher rate. Therefore, a mark-up that had the effect of raising the maximum allowable rate, on a per-channel basis, might simply allow the operator to recover a portion of the rate reduction required by the Commission's new rules.[2/]

Second, it would be reasonable to place a cap on the extent to which rates can be increased under this "fixed mark-up" approach. Given the number of new programming services that are currently available and are likely to be available each year, an annual limit on the amount that rates could increase as a result

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2/ This assumes, of course, that the maximum allowable rate under those new rules is itself reasonable. The current maximum allowable rates, we believe, are not reasonable, but that issue is the subject of pending judicial appeals. The point is that it would be reasonable to allow an increase in rates, when a channel is added, that is somewhat less than a reasonable average maximum allowable per-channel rate for the previously existing channels on the tier.

of adding channels would ensure that operators would choose to add those services that were most likely to appeal to subscribers and would not simply add worthless channels in order to reinstate pre-regulation rates. And it would allow operators to add new services to existing tiers on an incremental basis without allowing precipitous increases in maximum allowable rates. This approach would not, of course, cover the costs of major upgrades and rebuilds where a system substantially increased its channel capacity. But it would at least enable systems that undertook such upgrades to use *some* of the new channels for the addition of new programming services to regulated tiers, thus ensuring the continued growth and development of the types of services that cannot survive, at least at the outset, as à la carte offerings. Meanwhile, the Commission's "streamlined" cost-of-service approach would be available to operators who chose to allocate a more substantial proportion of their upgraded channel capacity to regulated tiers of programming.

Under a fixed mark-up approach, there may be incentives to add services that cost the operator very little and disincentives to add more expensive services. By definition, the operator retains the same amount regardless of the cost of the service, so that its profit margin is lower, all else being equal, when the cost of the service is higher. Moreover, adding a higher-priced service increases the overall charge to subscribers for the tier, and this may result in a loss of some subscribers, as compared to the addition of a lower-priced service that resulted in a lower charge to subscribers. But as a general matter, given the economics of launching new program services, that is precisely the balance of incentives that should be struck. More established, more expensive services are better candidates than new, unknown services to be offered on an unregulated à la carte basis. If the rules for adding channels to regulated tiers do not provide adequate incentives for the addition of such established services, providing such services à la carte and in discounted packages may be a real option.

But most new, unknown services cannot be launched successfully as à la carte services. In order to gain brand-name recognition and advertising revenues, they must be nurtured through exposure to subscribers as part of a tier that includes more established services. And they must be offered in a way that provides the operator with sufficient revenues at the outset to cover the costs and risks associated with adding the channels. The only way to provide such revenues to the operator is to allow a rate for such services that is sufficiently above the cost of the programming and of adding the channels -- even if the cost of the programming is very low.

In any event, while an approach based on a pass-through of costs plus a fixed mark-up may provide incentives to add inexpensive programming, it does not _foreclose_ the option of adding more expensive programming. If there were, instead, a flat per-channel allowance for adding new channels with no pass-through of programming costs, then operators would be unable to add channels that charged more than the allowable amount unless they expected a substantial increase in subscribership. A pass-through plus a fixed mark-up, on the other hand, enables operators to invest in higher-cost programming -- but operators will only do so where the higher costs represent higher quality, which, in their view, will ultimately result in correspondingly enhanced value to subscribers.

Once rates are initially increased for the addition of a channel, it will <u>then</u> be appropriate to treat any future <u>increases</u> in the costs of the programming on those channels as external costs, to be passed through with a reasonable mark-up.[3] The result will be that if the programming service succeeds in attracting viewers, it will be able to increase its fee to the operator. Even with a mark-up, the operator's margin may be progressively reduced. But this accurately reflects the dynamics of the marketplace. Under this approach -- a pass-through plus a fixed mark-up when channels are added and a pass-through plus a percentage mark-up when existing programming costs increase -- programmers can induce operators to carry their fledgling services by offering them at little or no cost, and can recover an increasing share of increasing subscriber fees if the

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3/ A 7.5% return on additional programming investments will not, under current economic conditions, be sufficient to warrant such investments.

programming succeeds in appealing to viewers. This is the way that new programming would be added to service tiers in an unregulated, competitive marketplace -- and it is the only way to enable operators to add new programming services in the current regulated environment.

June 3, 1994

TO: William Caton

FROM: Ed Hearst

SUBJECT: Ex Parte Filing

Attached per our conversation is the ex parte document we discussed. Please insert it in the record in MM Docket 92-266.

Thank you for your attention and assistance.

cc: Patrick Donovan